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TAGS: [ECON](#) [EFIN](#) [EINV](#) [ETRD](#) [BR](#)
SUBJECT: BRAZIL AWARDED INVESTMENT GRADE CREDIT RATING

SENSITIVE BUT UNCLASSIFIED--PLEASE TREAT ACCORDINGLY

REF: A. 07 Sao Paulo 0768
[1](#)B. Sao Paulo 0227

[1](#)1. (SBU) Summary: In a surprising move, credit ratings agency Standard and Poor's (S&P) upgraded Brazil's foreign currency sovereign credit rating to investment grade on April 30. Financial analysts had widely speculated that Brazil might earn the upgrade later in 2008, but S&P surprised analysts and investors alike, largely by upgrading Brazil amidst looming prospects of a global economic slowdown. As a result of this upgrade, investment in Brazil is widely expected to increase. However, some interlocutors told Econoff that the new-found status symbol could discourage the GOB from making any meaningful reforms especially tax reform. Brazil's status as an investment grade sovereign is tenuous and could still be blown off course by a change in external circumstances such as an economic slowdown in China. To solidify these gains, the GOB needs to make meaningful reforms. End Summary.

[1](#)2. (SBU) Over the past year, both in discussions with ratings agency heads in Brazil and local economic and financial analysts (reftels), nearly all agreed that Brazil would get the coveted upgrade to an investment grade foreign currency sovereign credit rating before 2009. Brazil was the last of the so-called "BRIC" (Brazil, Russia, India, and China) countries to receive an investment grade credit rating. A Credit Suisse economist told Econoff that he had expected Brazil to obtain investment grade in 2008 because of Brazil's improved solvency indicators such as foreign reserves of nearly USD 200 billion and economic policies that reduce uncertainty and improve economic stability. Indeed, S&P cited Brazil's stability in recent months amidst global financial market volatility, the anti-inflationary response of the Central Bank, continued strong revenue collection, and the fact that Brazil is now a net external creditor as some of the major reasons for the upgrade.

[1](#)3. (SBU) All economists that Econoff spoke to about Brazil's upgrade to investment grade agreed that it would increase investment flows into Brazil. Brazil closed out 2007 with USD 34.6 billion in foreign direct investment (FDI) and reached USD 8.8 billion in the first quarter of this year, up 34 percent over the same period last year. Luiz Figueiredo of MAUA Investments told Econoff he believes total FDI for 2008 will reach USD 50 billion. Bear Stearns

economist Emy Shayo said that the upgrade would be a confidence enhancer for companies willing to make long-term investments in Brazil and that she expected FDI flows to swell, especially after the U.S. economy rebounds.

¶4. (SBU) Giovanna Rocca, an economist at Unibanco, told Econoff that the upgrade would drive portfolio investment flows and should take Brazilian asset prices to higher levels. Indeed, markets in Brazil and New York reacted positively to the news with the Bovespa hitting an all-time high of 70,000 points on May 5 and many American Depository Receipts for Brazilian firms listed on the New York Stock Exchange up by as much as 10 percent. Similarly, Bovespa's Advisor for Development and International Relations Cristiana Pereira added that the upgrade would facilitate pension fund investment in Brazilian assets. Despite her optimism, institutional investors that are restricted to investment grade assets could take some time to move their positions into Brazilian assets. Local press highlighted in an interview with Calpers, the California state government employees' pension fund worth USD 245 billion, that Calpers had not previously been restricted from holding Brazilian assets. Indeed, Calpers currently holds USD five million in government paper and another USD eight million in Brazilian companies' stocks. Brazil can expect to wait for the mega-fund to buy up Brazilian assets because the Calpers representative stated that it revises its allocations every three years.

¶5. (SBU) Investment banks outside Brazil also agreed that the move was positive, but would take time for Brazil to see the effects. Fiona Gallagher, Global Head of Private Investments at Deutsche Bank in London, told Econoff that investors are keeping a close eye on Brazil and waiting for upgrades from Fitch and Moody's. Without two

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sovereign ratings as investment grade, large insurance companies cannot make significant investments in Brazil. She said many are starting to read up on Brazil in anticipation of a second upgrade, but opined that the big wave probably would not happen until at least one other ratings agency improves its rating. She also noted that the Japanese ratings agency R&I had already rated Brazil as investment grade; however, the National Association of Insurance Commissioners does not yet recognize R&I's ratings. She said R&I was working to have their status changed, which could expedite fixed-income investment flows to Brazil. UBS Global Asset Management Director for Growth Investors Stephen Derkash based in San Diego, California, told Econoff that the effects would not be immediate and they are dependent on other factors. He noted that although more fixed-income investors may now be able to invest in Brazil, he did not believe they would in the near-term because Brazilian debt is already expensive. New equity flows should enter the country, but investors will want to wait until growth picks up or fixed-income spreads gradually decline, making equity valuations more attractive, he said.

¶6. (U) Unlike other investment grade countries, the title itself probably will not drive down real Brazilian interest rates in the short-term. (Note: Real interest rates in India and South Africa, for example, declined from 3.9 to 1.6 percent and 9.4 to four percent, respectively, from one year before attaining investment grade to one year after. End Note.) Brazil, instead, probably will see interest rate hikes over the next year given widespread concerns about inflation (ref B). Press comments noted that the timing of the upgrade was also likely due in part to the Central Bank's aggressive tightening last month, in what many saw as consolidating its operational independence from the GOB.

¶7. (SBU) Brazil has already capitalized on its new status. The National Treasury on May 7 issued USD 500 million in dollar-denominated debt to U.S. and European investors at the lowest interest rates for this bond-class to date. The GOB plans to use the proceeds to retire more expensive debt. A Credit Suisse economist told Econoff that the upgrade should also reduce the average borrowing costs for companies and extend loan maturities.

¶8. (SBU) Brazil's award of an investment grade credit rating, however, is not the "magic" moment that President Lula proclaimed upon hearing about S&P's announcement. Solid finances are a

necessary but not by itself sufficient condition for broader economic development. Ratings are an opinion about a country's solvency and ratings can change. Uruguay is the most recent example of a country to win a foreign currency investment grade sovereign credit rating only to quickly lose it in 2002. Reforms are the only real way to protect against risk. Without meaningful reforms to generate sustained economic growth, Brazil is unlikely to maintain annual growth rates above five percent. David Fleischer, a long-time Brazil analyst, noted in his most recent analysis that no major reform has been approved in the last five years. In his view, the award of investment grade could provide even less incentives for the GOB to institute reforms.

¶9. (SBU) Comment: Brazil deserves recognition for its achievements over the last six years. The Lula Administration has brought net external debt down from 59.6 percent of GDP in 2002 to 42.8 percent last year. However, exploding tax revenues are helping to hide the GOB's expansionary fiscal policy and Brazil will need to tighten the purse-strings if there is a change in external circumstances, such as a deeper U.S. economic slowdown, a slowing Chinese economy, or a sharp fall in commodity prices. Indeed, the other dominant rating agency Moody's pointed to reduced government spending as a percent of GDP as one of the necessary precursors for the firm to upgrade Brazil to investment grade. As some market analysts have speculated, S&P's hasty upgrade may have been in part an effort to outdo its competition. Likewise, the potential rush of foreign capital following the upgrade would put even more upward pressure on the Brazilian currency, a growing concern that the GOB would need to face if exporters become more vocal. However, rather than lifting import restrictions to help absorb the foreign currency, the GOB will likely continue to concoct quick fixes to provide exporters with temporary relief. End Comment.

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¶10. (U) This cable has been coordinated with and cleared by Embassy Brasilia and coordinated with the US Treasury Financial Attache in Sao Paulo.

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